



ECONOMIC REVIEW: FIRST HALF 2019

Department of Economic Research

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CURRENT ECONOMIC DEVELOPMENTS THE CYPRUS ECONOMY

Cyprus' economy continued strengthening for seventeen consecutive quarters. After four consecutive years of robust growth, the Cyprus economy grew an annual 3,4% in the first quarter of 2019. Strong growth was supported by both domestic and external demand. Rising demand on the back of falling unemployment remains the key driver of growth. Growth is expected to remain strong in the medium-term horizon.

In absolute terms, the value of all final goods and services produced domestically at constant prices, i.e. real GDP, stood at €20,3 bn at end 2018, surpassing the pre-crisis peak level. Correspondingly, nominal GDP, the value of all final goods and services produced domestically at current prices, reached €20,7 bn in 2018, up from €19,6 bn in the previous year. The recovery phase has passed and the economy is settling into its growth phase.

What is encouraging for the new growth phase, helping to avoid the repeat of the boom-bust cycle experienced in the economy, is that the recent economic performance has not been driven by government through public spending and the related multiplicative role, nor is it funded from unsustainable credit-fueled consumption as observed in the pre-crisis period.

The main factor driving the increase in private consumption was the rise in household income, mainly driven by the increase in the number of employed people, rather than wage inflation. Private consumption was also supported by the flourishing tourism sector with positive

spillover effects in other sectors of the economy. While consumption continued to be a key recovery driver, investment demand also rebounded, particularly for large construction projects including tourism infrastructure, mainly funded by hefty inflows of foreign capital.

From a sectoral point of view, growth during 2018 and the first quarter of 2019 was mainly attributed to the sectors: Hotels and Restaurants, Retail and Wholesale Trade, Construction, Manufacturing, Professional, Scientific and Technical Activities and Administrative and Support Service Activities.

Public finances have been consolidated to a large extent to secure the sustainability of public debt. After having increased to around 103% of GDP in 2018, the government debt-to-GDP ratio is expected to decrease to 95% in 2019 and to continue to steadily decline thereafter, reaching 89% by 2020. Significant progress has been made to restructure and restore confidence in the Cypriot banking system. Cypriot banks have come a long way and are on a stronger footing. The non-performing exposures (NPEs) ratio in the banking system declined significantly in 2018 but it remains one of the highest in the EU. The large decrease was due to the removal of the Cyprus Cooperative Bank's sizeable NPEs portfolio from the banking system in September 2018.

The economic recovery along with the improved domestic financial conditions have created and maintained an environment of improved confidence in the Cypriot economy. International credit rating agencies have recently provided higher credit ratings for Cyprus and the country's largest domestic banks. In September 2018, Standard and Poor's upgraded Cyprus' long term credit rating "BBB", placing the economy on an investment grade after six years. Subsequently, in October 2018, Fitch upgraded the rating for the Cyprus sovereign to "BBB" from "BB+". In July 2018, Moody's Ratings upgraded the rating for Cyprus sovereign to "Ba2" from "Ba3", two notches below investment grade.

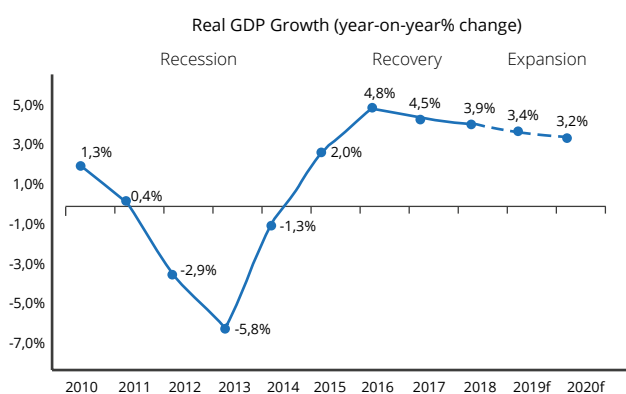
Taking advantage of the stable market backdrop and the recent rating upgrades, in February 2019, the Republic of Cyprus tapped the international capital markets, with an issue of a fifteen-year bond of €1 bn at a yield of 2,75%. Subsequently, in May 2019 the Republic successfully launched a new dual tranche transaction (in total €1.25 bn), consisting of a €500 mn 5-year bond (yield 0.673%) and a €750 mn 30-year bond (yield 2.835%). Since then, government bond yields have declined to historically low levels, allowing the government to refinance national debt on more favorable rates and with extended maturities.

The better than expected macroeconomic performance, does not justify complacency and does not signal a relaxation of efforts in further economic reform. The implementation of important structural reforms will help to strengthen the competitiveness of the Cypriot economy. Important reforms which are still outstanding relate to the implementation of the privatization agenda, along with reforms in key areas such as the Public Administration and local government, the justice system and education. Additionally, further efforts should be made to improve and broaden Cyprus' digital public services (e-government) including the promotion of electronic payments, which in turn will help develop a sustainable economy. Also, further promotion of electronic payments will enhance transparency in the economy and reduce the size of the informal sector and tax evasion, as electronic payments are far easier to track.

It is essential to use the current growth momentum for the implementation of the abovementioned reforms. Such reforms are easier to implement when economies are growing, since fiscal buffers can absorb the required transitional costs. The cost of the reforms may have negative effects on the economy's short-term prospects, but they will provide a stream of long-term economic benefits. Additionally, further enhancing the business environment and making it more conducive to growth would support both domestic and foreign investment. As an investment destination, Cyprus is offering new investment opportunities in the areas of commerce, services, development projects, shipping, education, health, technology, tourism, including the emergence of offshore oil and gas.

THE ECONOMY IN FIGURES

The economy has been exhibiting positive growth since the beginning of 2015 which accelerated during 2016 and 2017 and continued its solid expansion in 2018. According to the baseline macroeconomic scenario, growth is expected to be 3,4% in 2019 and 3,2% in 2020. Growth is expected to be supported mainly by private consumption, investment and continuous improvement in the labor market.



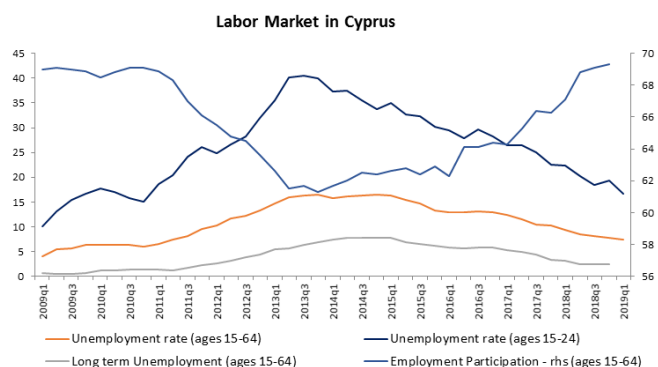
For the period of January – December 2018 revenue from tourism is estimated at €2,7 bn compared to €2,6 bn in the corresponding period of 2017, recording an increase of 2,7%. For the period of January – March 2019 revenue from tourism is estimated at €189 mn compared to €201 mn in the corresponding period of 2018, recording a decrease of 6,2%. For 2018, tourist arrivals amounted to €3,9 mn compared to €3,7 mn in 2017, recording an increase of 7,8%. For the period of January – April 2019 arrivals of tourists totaled 687 thousand compared to 683 thousand in the corresponding period of 2018, recording an annual increase of 0,5%.

With regard to consumption, retail sales volume rose an annual 1,9% for the period January – March 2019. The Index of Industrial Production for the period January - March 2019 showed an annual increase of 4,0%. For Manufacturing, for the period January – February 2019, the Industrial Turnover Index recorded an annual increase of 11,8%.

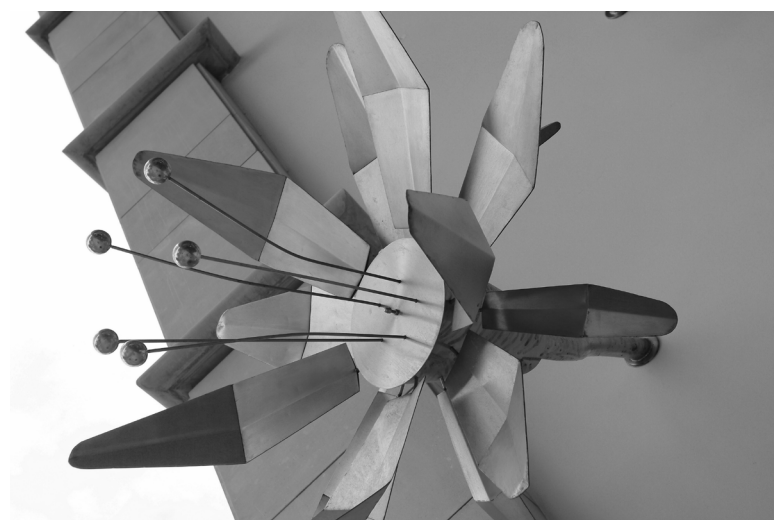
UNEMPLOYMENT AND INFLATION

The course of the steady recovery path is reflected in the labor market, which tends to follow the recovery with a time lag. The gradual reduction of the unemployment rate in Cyprus is mainly due to the increased employment rate of the last year.

In April 2019, the unemployment rate declined further to 6,9% of the labor force, recording a decrease compared to the same month of the previous year (7,2%). Also, during the second quarter of 2018, the unemployment rate for young persons aged 15-24 decreased to 19,3% of the labor force of the same age group in comparison to 22,6% during the equivalent period of the previous year.



In 2018 inflation rose by 0,8%. For the period January – April 2019, the inflation increased by 1,3% compared to the same period last year.



CYPRUS PROPERTY MARKET AND CONSTRUCTION

The housing market continues its recovery supported by local and foreign demand.

The housing market continued its adjustment during the third quarter of 2018, bringing the cumulative fall in prices since mid-2008 to 29% (Central Bank of Cyprus's Property Price Index (PPI)). In the third quarter of 2018, the PPI recorded a positive annual growth rate (1,6%). According to data from the Department of Land and Surveys, property sales recorded a new increase during 2018. Specifically, sales contracts submitted increased to 9.242 versus 8.734 in the previous year, an annual increase of 6%. Also, sales contracts submitted during the first five months of 2019 increased an annual 34%.



Real estate supply is accommodating the higher demand. Construction has steadily increased since 2016 as evidenced by the number of new properties. During the period January – March 2019, 1.591 building permits were issued compared to 1.515 in the corresponding period of the previous year. The total value of these permits increased by 13,2% and the total area by 12,7%. The number of dwelling units recorded an increase of 26,6%.

RECENT DEVELOPMENTS IN THE BANKING SECTOR

The Cypriot banking sector downsized significantly during 2018 as a result of Hellenic Bank's acquisition of certain assets and liabilities of Cooperative Cyprus Bank, the carve out of Cooperative Cyprus Bank's non-performing portfolio and the recent sales of loan portfolios by Hellenic Bank and Bank of Cyprus. The Cyprus banking sector has gone through a reformation phase and is now in a strengthened capital and liquidity position. Its size has been reduced to a moderate 2,8 times the GDP or about the EU average.

At the same, the banking regulatory and supervisory framework have been significantly strengthened. The improved conditions in the banking system are reflected through the increase in deposits of domestic households and non-financial corporations, the deleveraging of banks' balance sheets and the low lending interest rates indicating lower risk premiums and increased competition.

Banks are making progress in restructuring their nonperforming loan portfolios, as the latest available data indicate that loan restructurings are proceeding at a faster pace. In January 2018, problem loans have been reduced by 62% to €10.3 bn from a peak of €27.3 bn, a €17 bn decrease, equivalent to around 85% of the country's GDP.



FISCAL DEVELOPMENTS

Public finances have been consolidated to a large extent to secure the sustainability of public debt. The preliminary General Government fiscal results for 2018, include the fiscal burden of €1.7 bn, that was the result of the sale of the former CCB to Hellenic Bank, and indicate a deficit of €1.1 bn (-5,1% of GDP) for 2018, as compared to a surplus of €344 mn for 2017 (1,8% of GDP). Excluding the fiscal burden of CCB, the fiscal balance would register a surplus of €611 mn (+2,9% of GDP).

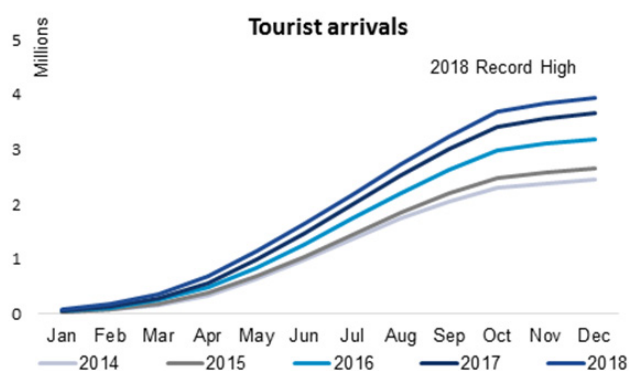
The preliminary General Government fiscal results for the period of January-April 2019 indicate a surplus of €547 mn (2,5% of GDP), as compared to a surplus of €427 mn for the corresponding period of 2018 (2,1% of GDP).

In addition to the substantial efforts made for the rationalisation and modernisation of the public sector, the best indication for the sustainability of public debt is the increased weighted average duration of public debt to 6,3 years from March 2019, compared to 4,7 years at the end of 2012. This leaves scope to pre-emptively manage the maturity profile and moderate the need of market funding.

The better-than-expected fiscal figures should not be regarded as permission to relax the efforts for the public sector's reform. The efforts for the rationalization of the public sector should continue and intensify to ensure the sustainability of the public debt, thus helping the Cypriot economy to regain its competitiveness.

THE IMPORTANT ROLE OF TOURISM

In 2018, the country achieved a new record in the tourism sector resulting in a positive impact on other sectors such as transport, construction, trade and food and accommodation. For 2018, tourist arrivals amounted to 3,9 mn compared to 3,7 mn in 2017, recording an increase of 7,8%, and outnumbering the total arrivals ever recorded in Cyprus during a year. This was due to the measures relating to the extension of the tourist season, the improved air connectivity, as well as the weaker competition from neighboring countries due to geopolitical tensions.



The tourism sector will continue to play an important role in the future of the Cypriot economy. Cyprus enjoys many comparative advantages which could be used in the right way so that the sector continues to be one of the main sources of growth. A continuous improvement of the island's tourism offering and the further lengthening of the tourism season can help attract visitors with a high purchasing power, leading to a substantial increase in revenue. The tourism industry remains one of the most important industries in Cyprus and must be safeguarded and properly utilized so that it will keep contributing over the foreseeable future.

PREDICTIONS FOR THE CYPRIOT ECONOMY

Cyprus' macroeconomic outlook is positive and is accompanied by a significant increase in real gross domestic product during 2018, robust employment growth and further improvement in key domestic indicators. Growth is expected to be supported by private consumption and investment and by an improving and robust labour market. Public expenditure is also expected to contribute positively to growth through higher investment expenditures. In the medium-term, the outlook of the economy is positive and growth is expected to continue albeit at a slower pace near its long-term average.

Despite the important steps taken towards restoring the positive economic climate, some degree of uncertainty remains, as the country

still has certain issues to resolve, such as the high level of NPEs, and high unemployment and the high private and public, which are however on a steady declining trend.

The high level of NPEs, continue to pose significant risks to the stability of the domestic banking system and to the outlook for the economy. The improved macroeconomic environment is expected to support banks' efforts to tackle the high level of delinquent loans. The modernization of the legislation on insolvency and foreclosure framework which is now in place is an invaluable tool towards this direction.

With regard to high public debt, the risks are mainly linked to the potential fiscal impact of Court rulings on past fiscal reforms and the financing needs of public hospitals during the first years of the national health system.

From an exogenous perspective, the economic outlook may be negatively influenced due to slower than expected growth in Europe and the global economy due to rising trade tensions between U.S.A and China and uncertainty effects of Brexit and a weaker pound. Also, increased geopolitical tensions in the Middle East and Eastern Mediterranean, could trigger adverse spillovers to economic confidence, tourism and consequently to the aggregate economic activity. At the same time, geopolitical tensions in neighbouring countries render Cyprus a safer tourist destination and could therefore counterbalance, to some extent, any potential reduction in tourist traffic from the UK. Additionally, developments over a potential reunification of Cyprus along with the exploitation of Cyprus' natural resources are being closely monitored to assess potential prospects and risks as they are evolving.

Upside risks pertain to the buoyant confidence leading to stronger domestic demand as well as if exploitations of Cyprus' natural resources prove financially viable.

Cyprus' macroeconomic outlook is positive, with GDP expected to continue growing. According to the baseline macroeconomic scenario, growth is expected to be 3,4% in 2019 and 3,2% in 2020. The pick-up in domestic demand is expected to be reflected in improved labor market conditions with unemployment decreasing to 6,6% in 2019 and 5,8% in 2020. Inflation in 2019 is expected to remain at relatively low levels, at around 1,0% and 1,2% in 2020.

CYPRUS MACROECONOMIC FORECASTS

	2018	2019	2020
GDP growth	3,9%	3,4%	3,2%
Unemployment	8,4%	6,6%	5,8%
Inflation (harmonised)	0,8%	1,0%	1,2%

Economics Research Department – Hellenic Bank Public Company Ltd
NB: This report is based on data which was available as at 31 May 2019.